



FIVE KEYS TO DEPLOYING ACTIVITY-BASED COSTING

Ken Whittaker

Setting the Stage

Even with the Department of Defense's informative ABC [Activity-Based Costing] Guidebook,¹ finding definitive answers to questions about this new and evolving discipline at times can be difficult. In fact, there are considerable differences of opinion among the experts regarding ABC. For example:

- The United States Government Accountability (formerly General Accounting) Office defines ABC as “a set of accounting methods used to identify and describe costs and required resources for activities within processes.”²
- The Consortium for Advanced Manufacturing-International (CAM-I), like other practitioners, clearly omits any references to accounting and defines

ABC as “a methodology that measures the cost and performance of activities, resources, and cost objects. Resources are assigned to activities, then activities are assigned to cost objects, based on their use. ABC recognizes the causal relationship of cost drivers to activities.”³

***One must use
substantial
professional judgment
and creativity for
successful [ABC]
implementation.***

The truth of the matter is that while the users of ABC do apply sound accounting principles, one must use substantial professional judgment and creativity for successful implementation.

We began implementing ABC in fiscal year (FY) 2001 as a way to determine the actual costs of the products and services we produce. By FY 2002, we had completed 15 rapid prototype models for the laboratories, support units, and headquarters. To evaluate our progress,

we conducted an internal survey, and we asked the Army Audit Agency to review and validate the models. While we still are in the early stages of implementing and using ABC, the lessons we learned may help other organizations reduce their learning curve, accelerate implementation, and achieve concrete results. The following are five of the

to 10 percent or less by the end of the fiscal year. As a result, there was no question about why ABC was being implemented, the results expected, the consequence of failure, and the necessary time frame.

Implementation of ABC was not the primary goal—the focus was on remain-

mission, competitive outsourcing, and top-down-driven efficiency initiatives, we felt that to remain competitive, we needed to focus on outputs as cost objects to make sound data-driven management decisions.

Perhaps one of the most difficult tasks for research organizations is to identify



Without a genuine customer focus, the identification of the outputs can be flawed, thereby causing disastrous results.

most important lessons that we in the U.S. Army Medical Research and Materiel Command learned while implementing ABC.

Putting ABC to Work— Five Keys

Support by Top Leadership

First and foremost, you must have the support of top leadership. Perhaps this is so obvious that it could go without saying. Clearly, ABC will not succeed as a grass-roots movement. Just as with other major changes, we began with the standard pronouncement of support for ABC by the commander, followed by policy memos. While this is a starting point, more than a simple mandate is needed to be successful.

Top leadership must develop a strong business justification for implementing ABC, set clear and measurable goals, and hold direct reports accountable for achieving them. In our case, Major General Lester Martinez-Lopez, Commanding General of the U.S. Army Medical Research and Materiel Command, explained at his Commander's Conference that, in order for the command to remain competitive in the future, we had to reduce overhead cost

ing competitive by reducing overhead costs. ABC was simply the vehicle to achieve the goal. Although it may have been possible for the organizational elements to accomplish this goal without implementing ABC, that outcome was unlikely.

The current appropriations-based and budget-based accounting systems encourage categorizing many costs as overhead and then simply allocating them arbitrarily to the products and services produced. The advantage of ABC is that it assigns costs based on the amount of resources used in order to produce the product or service, thereby greatly reducing the overhead cost category in the process. Since the most practical method for achieving the goal was to implement ABC, we encountered little resistance with its implementation.

Focus on the Customer

Of the three major components of ABC (resources, activities, and cost objects), the most difficult task was determining the cost objects. A cost object simply is an activity, output, or item whose cost is to be measured. In today's environment of declining budgets, redirection of resources to the Army's combat

their outputs, since research may not be applied to a final product for many years to come, if at all. In his book *The Seven Habits of Highly Effective People*, Stephen Covey states that the second of the seven habits is "Begin with the end in mind."

Similarly, the easiest and most effective way to identify outputs is to focus first on the customer. By focusing on those external customers who consume our research products or services, we were able to make the outputs less obscure. An additional benefit of a clear customer focus is that it may help to identify those products and services no longer in demand by the customer.

Without a genuine customer focus, the identification of the outputs can be flawed, thereby causing disastrous results. For example, in our rapid prototype models, many of the laboratories identified a cost object that they called organizational sustaining. Upon further investigation, the organizational sustaining cost object turned out to be activities such as acquisition, logistics, and resource management that were consumed within the command.

In other words, organizational sustaining was simply a new name for overhead. To make matters worse, the use of a separate organizational sustaining cost object eliminated those costs from the products or services that generated those costs.

Value Exceeds Cost

Within the research community, we are comfortable with data—lots and lots of data. In fact, in many cases we view more data as better. This, however, is not true when applying ABC. Complex models are difficult to maintain, and the data are expensive to gather. A complex model—with excessive cost data—is an anchor similar to that borne by organizations where people are micromanaged. While we may be motivated by the details that an extensive model can provide, the effect can be overwhelming, if not disastrous.

ABC assigns costs in two stages. In the first stage, the costs of resources are assigned to activities. In the second stage, activity costs are assigned to outputs. The pitfall comes in the first stage of the process: To avoid the potential data dump, we choose to roll up all activities that do not account for at least one-tenth of a full-time equivalent (FTE). The one-tenth FTE rule worked well for us because as a labor-intense organization, we view FTEs as one of our primary cost drivers.

Remember that ABC measures the cost of performing activities and assigns the cost to products and services. Focus on the accuracy of the big picture before deciding which activities to drill down into more detail.

Learn from Thyself

In addition to accurate output cost, ABC helps the user to seek out and study the best internal practices within the organization. By defining the business processes and activities—and trac-

ing their costs—ABC can identify the most cost-effective practices within the entire organization. This, however, can be accomplished only if the models are structured to compare like activities from the beginning.

For example, the U.S. Army Medical Research Institute of Chemical Defense has the same fundamental human resources requirements for hiring and developing employees as does the U.S. Army Medical Research Institute of Infectious Diseases. Similarly, the Walter Reed Army Institute of Research has the same basic resource management requirements for accounting and budgeting as does the U.S. Army Institute of Surgical Research. These processes, although performed at different laboratories, are common and can be benchmarked to produce superior performance—provided that each model uses the same activities to drive costs. Benchmarking is key, and we didn't limit it to support activities. Rather, we identified common research activities for benchmarking.

For this reason, it pays to identify the common business processes and activities before modeling begins. Once the activities are defined, the costs can be traced, and the most cost-effective practices can be recognized easily and exported to other organizations.


Build a Knowledge Base

While it is important to note that ABC and standard costing methodologies are not mutually exclusive, the concepts are very different. Don't assume that the existing accounting staff will understand

ABC or embrace it. As a consequence, you may have to build the technical expertise and establish a core of key staff to set the stage in order to implement and use ABC.

While it may be tempting to hand off the development of the model to consultants, it is just as likely that internal staff will be required. After all, who will better understand your business processes and activities well enough to develop meaningful models than your own staff members? We found that a crucial key to success is the use of a senior person to serve as a change agent—someone who understands and can oversee the projected detail.

Conclusion

In conclusion, ABC is an evolving discipline that requires substantial professional judgment and creativity if it is to be successfully implemented. Nevertheless, the effort can translate cost data into a reliable information source that management can employ to make sound decisions. Traditional accounting methods simply cannot offer this dimension. We hope that you will benefit from the lessons we've learned by starting off on the right path and avoiding pitfalls along the way. 

(The author wishes to thank Colonel Denise McCollum for her helpful information and review of drafts of this article.)

Endnotes

¹ DoD ABC Guidebook, <http://www.defenselink.mil/nii/bpr/bprcd/0201.htm>

² <http://www.gao.gov/>

³ <http://www.activitybasedmgmt.com/CAM-I.htm>



Ken Whittaker is a supervisory program analyst at the U.S. Army Medical Research and Materiel Command, Fort Detrick, Maryland. He holds a master's degree in business administration from Syracuse University, New York, and is a graduate of the Army Comptrollership Program. Whittaker is a member of the Western Maryland Chapter of ASMC.